

ASSISTANCE TO LOCAL GOVERNMENT

The Governor's Budget continues the state's commitment of working constructively with local governments to efficiently serve the people of California.

STATE-LOCAL FISCAL RELATIONSHIP

With the passage of Proposition 1A in 2004, local governments have a more stable funding relationship with the state, which can no longer shift costs, fail to reimburse mandates on a timely basis, or reallocate local revenues to benefit state priorities.

In addition to being protected from future property tax revenue shifts, local governments have experienced significant tax revenue increases since 2000-01, especially when compared to state government. While state revenues increased by an estimated 31 percent from 2000-01 to 2007-08, we estimate that city and county tax revenues increased by 50.4 percent and 80.5 percent, respectively. While cities and counties are using much of this new revenue to provide services to an expanding population, this nevertheless reflects a significant revenue gain for local governments in comparison to the state.

Local governments also have benefited from the Vehicle License Fee (VLF) "swap," which allows them to retain additional property tax revenues to backfill the revenues they lost when the VLF was reduced from two percent to 0.65 percent. The backfill amount annually grows with the increase in property tax revenues, instead of the annual increase in VLF revenues. Because property tax revenues have increased significantly more than VLF revenues since 2004-05, we estimate the VLF swap has allowed counties and cities to retain an additional \$2.1 billion in property tax revenues that otherwise would have been redirected to K-14 schools.

ASSISTANCE TO LOCAL GOVERNMENT

The Governor's Budget proposes no net reductions in discretionary assistance to local government. While the Budget eliminates the net operating deficit in 2007-08, future state budgets may have to be reduced. Given the many responsibilities that are shared between the state and local governments, particularly for law enforcement, the Administration looks forward to working with the cities and counties to further improve the state-local fiscal relationship to ensure the efficient delivery of services and to strengthen the long-term fiscal health of both state and local governments.

LOCAL GOVERNMENT FISCAL CONDITIONS

The economic outlook is generally positive for all regions of the state, and local revenues are expected to show continued growth. Due to the termination of ERAF III payments in 2006-07, the share of the property tax going to local governments has increased to approximately 63 percent. Historically, property taxes have been a very stable source of revenue for local governments, and they continue to show healthy growth. The recent growth in property tax revenue has also benefited the state by reducing the amount of General Fund that must be provided to K-14 schools.

Property tax revenues are expected to increase almost 12 percent in 2006-07, and by almost 10 percent in 2007-08. The projected growth rates translate to an additional \$2.5 billion for local governments in 2007-08, thereby increasing their total property tax revenues to approximately \$29.7 billion.

The moderating growth rate in 2007-08 property tax revenues is attributable to an estimated decline in new and existing home sales in 2006. This decline is tempered by retained growth in values that will impact the roll as properties are sold, by moderate growth in median home prices in 2006, and by continued growth in new commercial construction.

The sales tax, local governments' other major source of discretionary revenue, also is expected to show modest growth in 2007-08. The sales tax should provide over \$4.4 billion for discretionary purposes, in addition to \$3 billion for public safety, \$3 billion for health programs, and \$1.5 billion for county transportation purposes. Vehicle license fees, which provide partial funding for local health programs and discretionary revenue for cities, were up 4.5 percent in 2005-06 and are expected to show gains of four percent and 3.9 percent over the next two years.

While the outlook for local government revenues is positive, the growth in pension obligations and post-employment healthcare benefits continues to be a source of concern. Non-urban

areas have not experienced as much revenue gain, and individual counties and cities face a variety of fiscal challenges.

STATE AID TO LOCAL GOVERNMENT

INFRASTRUCTURE

The recently passed Proposition 1B provides \$19.9 billion in bond funds for transportation projects, of which approximately \$7.1 billion will go to local governments for their transportation infrastructure needs. The Governor's Budget proposes the following bond appropriations for 2007-08:

\$600 million for local streets and roads.

\$600 million for local transit.

\$200 million for state and local transportation partnerships.

\$65 million for grade separations.

\$10 million for seismic bridge upgrades.